Invested interests: the politics of national economic policies in a world of global finance

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A striking characteristic of the contemporary international economy is the great mobility of capital across national borders. Technological innovations, economic trends, and government policies have brought international investment to extremely high levels. Many business executives, politicians, and observers believe that capital now moves so freely that the financial markets of industrialized countries are essentially subsets of one global market. This is widely regarded as a fundamental change in the international economy—something new or at least not seen since the classic gold standard. It is also widely believed to have generated such prominent developments as European Community (EC) movement toward a single currency, harmonization of taxes across national borders, and international convergence of macroeconomic policies.

Economists have devoted a great deal of time and energy to analyzing the economic implications of the movement of capital across national borders. Other social scientists have also analyzed the political implications of international investment. The studies of this latter group have tended to focus on one or another subset of the issue, such as multinational corporations in developed and developing countries, foreign borrowing by developing nations, and the politics of international banking.[1] Despite the quantity and quality of work on

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1. For prominent examples from each of these issue-areas, see Helen V. Milner, *Resisting Protectionism: Global Industries and the Politics of International Trade* (Princeton, N.J.: Princeton University Press, 1988); Peter Evans, *Dependent Development: The Alliance of Multinational, State, and Local Capital in Brazil* (Princeton, N.J.: Princeton University Press, 1979); David G. Becker et al., *Postimperialism: International Capitalism and Development in the Late Twentieth Century* (Boulder, Colo.: Lynne Rienner, 1987); Robert Kaufman and Barbara Stallings, eds., *Debt and*

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specific aspects of the politics of cross-border investment, this literature remains disjointed and short on general analytic principles.

This article proposes a framework for analyzing the politics of international capital mobility. It focuses on the distributional implications of cross-border capital movements and on the distributional implications of various economic policies in light of the high degree of international capital mobility.

The first section describes just how mobile capital is today and discusses the implications of existing levels of financial integration for national economic policy autonomy. It argues that while financial capital is extremely mobile across borders, other types of investment (especially in equities and sector-specific capital) are far less mobile. In this context, foreseeable levels of international capital mobility restrict but do not eliminate the possibility for national economic policies. Sectoral policies remain feasible, as do policies whose goals directly or indirectly involve the exchange rate.

The second section of the article examines the policy preferences of various socioeconomic groups toward financial integration. It emphasizes the differential effects of the increase in capital mobility and focuses on questions concerning which actors are better (or worse) off after financial integration than before and how the various actors can be expected to respond politically to this change in the economic environment. The conclusion here is twofold. Over the long run, international financial integration tends to favor capital over labor, especially in developed countries. But in the shorter run, which is more relevant to politics and policies, the issue is more complex: in the developed world, financial integration favors capitalists with mobile or diversified assets and disfavors those with assets tied to specific locations and activities such as manufacturing or farming.

The third section of the article explores what high levels of financial integration imply for the policy preferences of economic interest groups in regard to such other issues as macroeconomic policy and the exchange rate. The section takes a high level of capital mobility as given, to see how various interest groups are expected to behave in this environment. It argues that international capital mobility tends to remake political coalitions by way of its impact on the effects of national policies. The political division between producers of tradable goods and producers of nontradable goods and services is likely to become more important, as are distinctions between internationally diversified and undiversified investors. All of these factors have significant implications for the analysis of politics and economic policy in the advanced industrialized nations.

Development in Latin America (Boulder, Colo.: Westview Press, 1989); Benjamin J. Cohen, *In Whose Interest? International Banking and American Foreign Policy* (New Haven, Conn.: Yale University Press, 1987); and Charles Lipson, *Standing Guard: Protecting Foreign Capital in the Nineteenth and Twentieth Centuries* (Berkeley: University of California Press, 1985). The bodies of literature, of course, are far too large to cite or discuss here.

The relationship between international capital mobility and national policies is a prominent example of the much-discussed impact of external conditions on domestic politics.[2] Elucidating this specific relationship thus also serves the broader purpose of clarifying the domestic effects of international trends. The article, then, both develops an integrated approach to the politics of international capital movements and addresses more general conceptual issues about the interaction of the domestic and international political economies. In so doing, it presents a summary and empirical illustrations not only of the direct impact of international capital mobility on the effectiveness of national economic policy but also of the distributional effects of capital mobility on the social groups whose demands themselves affect national economic policy.

Capital mobility and national economic policies

It would be foolish to inquire about the effects of integrated international capital markets on interest group competition over national economic policy if such policy could not be implemented in a financially integrated world or if contemporary international capital markets were not in fact highly integrated. The initial question therefore concerns the degree to which national economic policy autonomy is compromised by existing levels of international capital mobility.

The events of the 1970s and the 1980s have led many to conclude that capital mobility severely limits or contravenes national policy. Between 1978 and 1982, for example, private financial inflows swamped Chile's conservative policies even as private financial outflows thwarted Mexico's free-spending policies. In mid-1981, the economic expansion attempted by the new French Socialist government rapidly confronted a large capital outflow and a run on the franc, leading to a reversal of the policies soon after their adoption.[3] Parallel stories about government efforts hampered by capital and currency movements could be told about many other developing and developed countries in the past two decades. Some observers have drawn dire conclusions, such as that of John Freeman, who observed that in the context of the globalization of finance "the nation state has become at best immobilized and at worst obsolete."[4]

2. The two quintessential works on this subject are Peter Gourevitch's *Politics in Hard Times: Comparative Responses to International Economic Crises* (Ithaca, N.Y.: Cornell University Press, 1986) and Ronald Rogowski's *Commerce and Coalitions: How Trade Affects Domestic Political Alignments* (Princeton, N.J.: Princeton University Press, 1989).

3. Jeffrey Sachs and Charles Wyplosz, "The Economic Consequences of President Mitterand," *Economic Policy* 2 (April 1986), pp. 262–322.

4. See John Freeman, "Banking on Democracy? International Finance and the Possibilities for Popular Sovereignty," mimeograph, University of Minnesota, 1990. From a politically different quarter, former Citibank chief executive officer Walter Wriston has said similar things about the impact of financial internationalization—but approvingly: "It's a new world and the concept of sovereignty is going to change. . . . The idea of fifteenth-century international law is gone. It hasn't laid down yet, but it's dead. It's like the three-mile limit in a world of Inter-Continental Ballistic

The first step in evaluating the effects of contemporary levels of international capital mobility is to get a clear picture of where the levels stand in relation to the past. Long-term capital movements across borders were relatively limited for the first twenty-five years after World War II and took place primarily in the form of direct investment. Today, long-term international investment flows are extraordinarily large, and direct investment has been dwarfed by other, more arms-length, forms of cross-border capital movements.

According to one source, net international bond and bank lending was $440 billion in 1989, up from $180 billion just five years earlier. Capital outflows from the thirteen leading industrialized countries averaged $444 billion in 1989, with almost two-thirds of the amount consisting of portfolio investment, in contrast to $52 billion in the late 1970s, with two-thirds consisting of foreign direct investment. Capital outflows were equivalent to 15 percent of world merchandise trade in 1989, in contrast to 7 percent in the late 1970s.[5] According to another source, the outstanding stock of international bank and bond lending was $3.6 trillion in 1989, equivalent to 25 percent of the aggregate gross national product (GNP) of the industrialized countries, in contrast to under $200 billion and 5 percent of aggregate GNP in 1973.[6]

Recent changes in regulations and technology have made it possible for money to travel across borders almost instantly, giving rise to massive short-term international financial transactions. In April 1989, foreign exchange trading in the world's financial centers averaged about $650 billion *a day,* equivalent to nearly $500 million a minute and to forty times the amount of world trade a day. Markets for short-term international financial instruments are comparably large, although exact figures are not available.[7]

Impressive as these numbers are, they do not amount to full international capital mobility. In fact, economic studies have consistently shown that borders and currencies are still substantial barriers to investment flows.[8] Although

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Missiles." Wriston is cited in my *Banking on the World: The Politics of American International Finance* (New York: Harper & Row, 1987), p. 115. See also Walter Wriston, *Risk and Other Four-Letter Words* (New York: Harper & Row, 1986).

5. Bank for International Settlements (BIS), *Sixtieth Annual Report* (BIS: Basle, 1990), pp. 63, 82, and 125.

6. See Morris Goldstein, Donald Mathieson, and Timothy Lane, "Determinants and Systemic Consequences of International Capital Flows," in *Determinants and Systemic Consequences of International Capital Flows* (Washington, D.C.: International Monetary Fund, 1991), p. 5. This assumes a low level of international bond lending in 1973, which is almost certainly the case. Exact figures are not available.

7. See BIS, *Sixtieth Annual Report,* pp. 208–9. See also pp. 146–52, which offer data regarding some short-term instruments and indicate that open positions in interest rate futures and options totaled about $1.6 trillion at the end of 1989.

8. The early classic work was M. Feldstein and C. Horioka's "Domestic Savings and International Capital Flows," *Economic Journal* 90 (June 1980), pp. 314–29. For more on the issue and debates over it, see Ralph Bryant, *International Financial Intermediation* (Washington, D.C.: Brookings Institution, 1987), pp. 82–86. For a recent test, see Tamim Bayoumi, "Saving-Investment Correlations: Immobile Capital, Government Policy, or Endogenous Behavior?" *IMF Staff Papers* 37 (June 1990), pp. 360–87.

these barriers have been and are still being reduced, there are a number of reasons why international investment is by no means yet a seamless web. First, movement of capital across borders still involves country and currency risks. Investors must take into account the possibility that assets in one country may be riskier than those in another country and that movements in exchange rates may affect the return on their investments. Of course, both of these problems are addressed by adjustments to asset prices and returns and by forward markets, but they imply that capital movements among industrialized countries are more difficult than capital movements within them.[9]

Second, while some forms of capital do move quite easily across borders, others remain more geographically specific. Most assertions of full international capital mobility refer to international transfers of financial assets, especially bonds and bank claims. Equity markets appear to be far less integrated,[10] and other forms of capital still less so. In most interpretations, this is because many forms of capital, such as technological and managerial knowledge, skills, and networks, are specific to their current use and cannot easily be transferred from place to place.[11] Although detailed analyses do not exist, most observers would probably agree that financial capital is most mobile across borders, followed by equities and then by firm- or sector-specific capital assets.[12]

The greater international mobility of financial assets, the more modest international mobility of other assets, and the continued importance of unexpected exchange rate movements must all be taken into account in assessments of national policy autonomy in the contemporary international economy. The appraisal can be divided into policy targeted at well-defined segments of the economy (industries, sectors, and regions) and policy of macroeconomic import. The baseline is the assertion that asset markets are

9. The most careful assessment of the Feldstein-Horioka findings, updated through the late 1980s, emphasizes the great increase in capital mobility and the continued importance of currency premiums. See Jeffrey A. Frankel, "Quantifying International Capital Mobility in the 1980s," in Douglas Bernheim and John Shoven, eds., *National Saving and Economic Performance* (Chicago: University of Chicago Press, 1991), pp. 227–60.

10. For rough evidence on intranational and international stock price differentials, see Barry Eichengreen, "Is Europe an Optimum Currency Area?" mimeograph, University of California at Berkeley, 1990, pp. 6–9. The differentials may have to do with nontransferable advantages accruing to national owners, such as greater access to information or to monitoring and enforcement mechanisms.

11. The modern theory of foreign direct investment is based on the proposition that multinational firms exist precisely because they facilitate (but do not make costless) the international transmission of such specific assets. The classic statement by Caves is still probably the most appropriate here. See Richard E. Caves, "International Corporations: The Industrial Economics of Foreign Investment," *Economica* 38 (February 1971), pp. 1–27.

12. This is a conclusion made by Frankel in "Quantifying International Capital Mobility in the 1980s." One indication of the high degree to which markets for financial assets are integrated is the virtual disappearance of significant spreads between domestic and offshore interest rates in most currency instruments of members of the Organization for Economic Cooperation and Development (OECD). Regarding this subject, see Goldstein, Mathieson, and Lane, "Determinants and Systemic Consequences of International Capital Flows," pp. 7–11.

internationally linked to varying degrees: financial markets are closely linked, equity markets are less connected, and markets for firm- and sector-specific capital are quite nationally segmented. In other words, among industrialized countries, financial capital flows freely but other assets flow relatively less freely or very little.

Inasmuch as capital is specific to location, increased financial integration has only limited effects on policies targeted at particular industries. Whether or not a sector-specific policy is effective depends greatly on how easily firms can enter the sector. Financial markets can affect the ease of entry by extending funds to new firms. The easier it is for new firms to enter the sector, the more quickly the benefits of the policy to preexisting firms will dissipate and thus the less effective the policy will be. This is a general feature of sector-specific policies and holds as long as financial capital is mobile domestically; it would be true even if capital were not mobile internationally.

Where cross-border financial flows reduce entry barriers to a favored sector, they contravene sector-specific policy. International capital mobility may have increased the ability of foreign producers to respond to trade protection by locating in the protected market; inasmuch as the purpose of protection was to support locally owned firms, this objective may be frustrated. The proliferation of Japanese-owned automobile factories in the United States in response to automobile import controls may have been made easier by the integration of financial markets and may have reduced some of the benefits of the controls to shareholders and employees of American-owned automobile manufacturers.[13]

All in all, however, increased financial capital mobility probably has little effect on most sector-specific policies. Supporters of such policies can generally design them to avoid their frustration by financial flows, domestic or international. Financial capital mobility, within or across borders, is not likely to affect the impact of cash transfers to farmers on their incomes. Nor can financial flows significantly impede government health and safety standards. Financial integration may make it more difficult to design some sector-specific policies to avoid undesirable side effects (namely, benefits accruing to untargeted firms), but it rarely makes them unsustainable.

On the other hand, integration of financial markets has significant effects on the effectiveness and the differential distributional impact of national macroeconomic policies. To get a handle on the issue, it is useful to start with what

13. Although I am unaware of any studies of this phenomenon, arguments to this effect are frequently heard among American competitors of the Japanese transplants, often in the context of complaints over the Japanese firms' access to low-cost Japanese funds. There are reasons to doubt the accuracy of the argument, however. First, most foreign direct investment is funded in the host country. Second, if Japanese firms have privileged access to Japanese finance, then financial markets are not fully integrated. The result might be due to preferential ties among Japanese financial and nonfinancial firms, which would constitute a "natural" barrier to financial capital mobility. Further study in this regard is required. A related issue is the effect of foreign-owned branch plants on political lineups in the host country. For anecdotal evidence that Japanese investment in the United States has created or reinforced domestic interest groups that favor freer trade, see "Influx of Foreign Capital Mutes Debate on Trade," *The New York Times,* 8 February 1987, p. I13.

might be called the Mundell-Fleming conditions, taken from the most influential approach to payments balance developed in the early 1960s.[14] These conditions include the possibility that financial assets may be fully mobile across borders. (In what follows, I use "capital mobility" to mean the mobility of financial capital, as does the literature in question.)

Simply put, the Mundell-Fleming approach indicates that a country can have at most two of the following three conditions: a fixed exchange rate, monetary policy autonomy, and capital mobility. Without capital mobility, national authorities can adopt and sustain a monetary policy that differs from the policies of the rest of the world and can hold their exchange rate constant; however, with mobile capital, the attempt will be contravened by financial flows. Assume the authorities want an expansionary monetary policy. Without capital mobility, a fall in interest rates will lead to a rise in demand, and the economy will be stimulated (we ignore longer-term effects on the payments balance). With capital mobility, reduced domestic interest rates will lead to an outflow of capital in search of higher interest rates abroad, and long before monetary policy has a real effect, interest rates will be bid back up to world levels.[15]

The reason for the result is straightforward: if capital is fully mobile across borders, interest rates are constrained to be the same in all countries and national monetary policy can have no effect on national interest rates. However, to go back to the original conditions, if capital mobility is given (or imposed), monetary policy can be effective if the value of the currency is allowed to vary. Monetary policy operates, in other words, via exchange rates rather than via interest rates as in a typical closed-economy model. With capital mobility, monetary expansion greater than that in the rest of the world causes a financial outflow in which investors sell the currency; the result is currency depreciation. Depreciation in most cases stimulates the economy as prices of foreign goods rise relative to prices of domestically produced goods, thereby increasing local and foreign demand for locally produced goods.[16]

A parallel story can be told about fiscal policy. If capital is not mobile and the exchange rate is fixed, expansionary fiscal policy raises national interest rates as the government finances increased spending by floating more bonds. The

14. See the following works of Robert A. Mundell: "The Appropriate Use of Monetary and Fiscal Policy Under Fixed Exchange Rates," *IMF Staff Papers* 9 (March 1962), pp. 70–77; "Capital Mobility and Stabilization Policy Under Fixed and Flexible Exchange Rates," *Canadian Journal of Economics and Political Science* 29 (November 1963), pp. 475–85; and "A Reply: Capital Mobility and Size," *Canadian Journal of Economics and Political Science* 30 (August 1964), pp. 421–31. The basic model can be found in any good textbook discussion of open-economy macroeconomics; a useful survey is W. M. Corden's *Inflation, Exchange Rates, and the World Economy,* 3d ed. (Chicago: University of Chicago Press, 1986).

15. The argument presented here is in simplified form. Variation in monetary autonomy is actually along a continuum, not dichotomous: the choice is not starkly between full monetary independence and none at all; it is instead among different degrees of autonomy.

16. This ignores the potential contravening effects of the depreciation on national income; that is, it assumes that substitution effects dominate income effects or that expenditure switching dominates expenditure reduction.

resultant "crowding out" of private investment dampens the expansion. However, if capital moves freely across borders, bonds floated to finance increased government spending are bought by international investors, and there is no effect on interest rates, which are set globally.[17] Relaxing the fixed exchange rate constraint has different effects with fiscal policy than with monetary policy. If the exchange rate varies, as foreigners buy more government bonds the resultant capital inflow causes a currency appreciation that tends to reduce domestic demand for domestically produced goods and thus to dampen the fiscal expansion.[18]

The general point is that in a world of fully mobile capital, national policy cannot affect the national interest rate;[19] it can, however, affect the exchange rate. The above discussion of open-economy macroeconomics is meant simply to highlight this result.

It may seem unimportant that the world has changed from one in which national macroeconomic policy operated primarily via interest rates to one in which policy operates primarily via exchange rates, but several points to defend the significance of this observation can be made. First, the distributional effects of interest rate changes are different from those of exchange rate changes. If monetary expansion in a stylized world before capital mobility (BCM) meant lower interest rates, then monetary expansion in a stylized world after capital mobility (ACM) means depreciation. To take one distributional example, lower interest rates are good for the residential construction industry, while depreciation is bad for it inasmuch as it tends to switch domestic demand away from nontradable goods and services. By the same token, manufacturers might have been more sympathetic to a tight money stance in the past, when the principal effect of this stance was to raise interest rates, than they are now, when the principal effect is a currency appreciation that tends to increase import penetration. This means that policy preferences of economic interest groups, and therefore political coalitions, are likely to differ between the BCM and ACM worlds. I later return to this point and discuss it in detail.

Second, although by definition there is an international component to exchange rate changes, there is not necessarily an international component to

17. The point is not that foreigners buy all the government bonds but, rather, that the increased domestic demand for credit is met by an increased supply of credit as capital flows in, with the result that the price of credit remains unchanged. This of course assumes that the deficit country is not large enough to affect world interest rates, which may not always be the case. It also assumes that the government does not engage in monetary policies that accommodate the fiscal expansion.

18. For a good survey and evaluation, see Michael M. Hutchison and Charles A. Pigott, "Real and Financial Linkages in the Macroeconomic Response to Budget Deficits: An Empirical Investigation," in Sven Arndt and J. David Richardson, eds., *Real-Financial Linkages Among Open Economies* (Cambridge, Mass.: MIT Press, 1987), pp. 139–66.

19. More accurately, it does not affect the *covered* interest rate—that is, the interest rate minus (or plus) the market's expectation of currency movements. Obviously, if investors expect a currency to fall, they demand a higher interest rate for securities denominated in it, and vice versa. Covered interest parity appears to have held well from the mid-1970s onward among almost all major currencies.

interest rate changes. If monetary expansion simply reduces national interest rates, chances are that most foreigners will be indifferent. If, however, it leads to currency depreciation in the expansionary country, foreigners are likely to be concerned about their resultant loss of competitiveness.[20]

Third, the focus on how macroeconomic policy takes effect through the exchange rate helps clarify some observed anomalies of the ACM world. If an American administration in the BCM world had pursued fiscal expansion and monetary stringency, the result might well have been that the policies canceled each other out: tight money would have reinforced the "crowding out" effects of the fiscal expansion. As it was, however, in the ACM world, the Reagan-Volcker fiscal expansion and monetary stringency of the early 1980s had a markedly different impact. Fiscal policy was largely financed by foreign borrowing, which reduced or eliminated the effects of crowding out and contributed to appreciation of the dollar. At the same time, tight money reinforced the rise of the dollar by strengthening the international investment attractiveness of dollar-denominated securities. The result was striking both on macroeconomic grounds, as the dollar soared and the United States became a major net debtor to the rest of the world, and on distributional grounds, as the dollar appreciation devastated U.S. producers of tradable goods (manufacturing and agriculture) and favored producers of nontradable goods and services (real estate, health care, leisure activities, and education).

To summarize this section, financial capital moves across the borders of developed countries with great ease, while other asset markets are less integrated and some capital remains quite fixed. In this context, while global financial integration may reduce the efficacy of some sector-specific policies, it does not impede most of them. And while international financial integration does not make national macroeconomic policy obsolete, it does shift the effect of macroeconomic policy from the interest rate to the exchange rate. These features of the ACM world are expected to have a significant impact on the interests of various domestic economic interest groups. I return to ACM interest group competition over economic policy after first looking at the expected effects of the shift from BCM to ACM itself.

The distributional effects of capital mobility

The distinction I draw here is nuanced but important. On the one hand, I am interested in how economic agents are expected to act in a world characterized by capital mobility: What sorts of policies will be pursued by what sorts of groups and coalitions? On the other hand, I am interested in how the shift from

20. For an illuminating discussion of cross-border effects, see Michael Mussa, "Macroeconomic Interdependence and the Exchange Rate Regime," in Rudiger Dornbusch and Jacob Frenkel, eds., *International Economic Policy: Theory and Evidence* (Baltimore, Md.: Johns Hopkins University Press, 1979), pp. 160–204.

a pre-1970 world of limited capital mobility to a post-1980 world of relatively high capital mobility affected the interests and influence of economic agents: Who gained and who lost as we went from capital immobility to capital mobility? And what are the political implications of these gains and losses? In other words, in one context I analyze the dynamics of the ACM world; in another context, I compare conditions in the BCM world with those in the ACM world.

The first set of questions addressed in this section pertains to the overall impact of international financial integration on major economic interest groups in advanced industrialized societies. Once again, I have recourse to rudimentary tools of economic analysis. There are, however, several different (albeit potentially complementary) approaches that contend for attention. Many analyses focus implicitly or explicitly on the portfolio choice approach or on an application of the Heckscher-Ohlin model of international trade. While these give interesting insights, I believe that they are not directly relevant to our political and policy questions. After reviewing them, then, I summarize and discuss the "specific-factors" model, which I believe is best suited to assessing the distributional effects of increased capital mobility and to determining the impact of these distributional effects on lobbying for policy.

Perhaps the most common and simplest possible cut into the problem is to look at increased capital mobility from the standpoint of investors facing portfolio decisions, whom it must help. It can hardly be bad for capitalists to have more investment options than before, which is what capital mobility gives them. By the same token, increasing the options of capital presumably reduces those of labor by making it less costly for capital to move rather than accede to labor demands.

This surmise captures important effects of increased financial integration. The wider menu of investments open to asset-holders increases their influence on governments, labor, and others. The 1980s may have indeed seen a secular shift in response to increased capital mobility, in which governments all over the world were forced to provide more attractive conditions for capitalists. Such conditions include everything from lower wealth and capital gains taxes to relaxed regulation of financial activities and labor relations. In a world in which financial capital moves freely across borders, it is difficult for one country to insist on stiff capital taxation when other countries are removing or reducing it. Inasmuch as this effect holds, increased financial integration implies an across-the-board, lasting increase in the social and political power of capital.[21]

21. American tax reform in 1986, for example, was followed by widespread OECD movement toward the new American corporate tax rates. By 1989, direct corporate tax rates in the principal EC member countries were all in the 35 to 42 percent range. See Price Waterhouse, *Tax: Strategic Corporate Tax Planning* (London: Mercury Books, 1989). Across industries, there is evidence that such footloose sectors as finance face lower effective tax rates. In the United States in 1983, for example, while twenty-four nonfinancial industries paid an average effective federal income tax rate of 17.5 percent, the three financial sectors (insurance, investment, and financial services companies) paid an average of 8.5 percent. See "New Threat to Smokestack America," *The New York Times,* 26 May 1985, p. 3:1.

But this picture is incomplete, for it ignores the dynamic effects of aggregate portfolio choices on asset-holders. The ability of capital to move freely across borders can in fact be bad for capitalists in a given country or good for labor in it. The result depends on the country's underlying endowment of capital and other resources, and this leads some to believe that the Heckscher-Ohlin approach is the appropriate analytic tool.

According to the Heckscher-Ohlin trade model, the effects of goods movements on returns to factors will vary according to whether the factors are locally scarce or abundant. Perhaps the best-known extension is the Stolper-Samuelson theorem, which posits that protection (that is, decreased trade) benefits the locally scarce factor: protection is good for labor in a labor-poor country and is good for capital in a capital-poor country. The intuition is straightforward. With trade, demand for the product in which the country has a comparative advantage will rise, and this comparative advantage is a function of how well endowed the country is with various factors. A labor-rich country tends to export products that use labor intensively; the more the country trades, the more labor is used, and the more wages rise. Trade and factor movements are substitutes: exporting labor and labor-intensive products have the same effect, as do exporting capital and capital-intensive products.

In the Heckscher-Ohlin view, then, increased capital mobility (like increased world trade) benefits capital where it is abundant and hurts capital where it is scarce. Capital flows out of capital-rich countries, raising the return to local capital, and flows toward capital-poor countries, lowering the return to local capital. The effect is analogous to that examined by Ronald Rogowski, who assessed periods in which there was an exogenous increase or decrease in world trade to explore the Heckscher-Ohlin effects on national politics.[22]

To illustrate the above points, we can compare two countries with opposite sets of endowments. In the BCM world, the first country is rich in capital and poor in labor, so its local interest rates are relatively low and its local wages relatively high. In the ACM world, capital is free to move to countries in which the rate of return is higher; the local interest rates rise to the world level, and local wages fall. In this case, the result favors capital and disfavors labor, but this is purely a function of the beginning endowments—which are characteristic of most developed countries. Now take the opposite case. In the BCM world, the second country is poor in capital and rich in labor, so its local interest rates are relatively high and its local wages relatively low. In the ACM world, capital will flow in, reducing the local interest rates and tending to raise wages. In this case, since the local rate of return on capital is constrained to fall to the (lower) world level, local capitalists are harmed while local workers benefit.

This may capture some of what has happened as capital mobility has advanced. Capitalists in the developed world (in countries relatively rich in capital) have probably benefited from international capital mobility. It might be argued that the developing countries' access to international financial

22. Rogowski, *Commerce and Coalitions.*

markets tended to strengthen labor (perhaps by increasing investment in labor-intensive activities), but this seems far from clear-cut.

In fact, while the Heckscher-Ohlin approach may be useful in predicting long-term economic trends, it is probably not a very good way to analyze the distributional effects of international factor movements, for several reasons. First, it is extremely sensitive to the number of factors involved. The predictions are straightforward with two factors, but they become ambiguous at best with more than two. Second, it assumes that capital, labor, and other factors can move costlessly from one activity to another within a country, even if they are internationally immobile. This is certainly untrue, since an automobile factory cannot costlessly be converted into a brewery, nor can a seamstress costlessly become an aerospace engineer. Although factors of production may move from one use to another over the long run, they cannot do so in the short and medium run, which is the time frame more relevant to political analysis. And, third, empirical evidence suggests that political behavior, especially with regard to economic policy, is less commonly factoral (laborers as a class, capitalists as a class) than sectoral (the steel industry, the dairy farming industry).[23]

As useful as the Heckscher-Ohlin approach may be for long-term economic analysis, it is more appropriate to investigate the political economy of international trade and capital movements with an approach which assumes that at least some factors of production are specific to a particular use for at least the short run. In this "specific-factors" model, changes in the relative prices of goods have their principal effect on the sector-specific producers of the goods, rather than on a whole class of factor-owners. Thus, an increase in milk prices is good for dairy farmers rather than landowners as a whole; a decline in clothing prices is bad for owners and workers in the garment industry rather than for capitalists or workers as a class.[24]

23. The classic statement is Stephen Magee's "Three Simple Tests of the Stolper-Samuelson Theorem," in Peter Oppenheimer, ed., *Issues in International Economics* (London: Oriel, 1980), pp. 138–53. In *Commerce and Coalitions,* pp. 16–20, Rogowski addresses these objections and more; needless to say, I am unconvinced by his treatment. Benjamin J. Cohen has pointed out to me that this simple transfer of the Heckscher-Ohlin approach from trade to capital movements ignores the inherent differences between the two realms and especially the importance of expectations in determining asset prices (and therefore capital movements). This may be another reason to avoid a straightforward application of the approach to capital movements.

24. The seminal modern statement is Ronald W. Jones's "A Three-Factor Model in Theory, Trade, and History," in Jagdish Bhagwati et al., eds., *Trade, Balance of Payments, and Growth* (Amsterdam: North-Holland, 1971), pp. 3–21. Two other important articles, which essentially argue for combining specific factors in the short run with the Heckscher-Ohlin approach in the long run, are Wolfgang Mayer's "Short-Run and Long-Run Equilibrium for a Small Open Economy," *Journal of Political Economy* 82 (September 1974), pp. 955–68, and Michael Mussa's "Tariffs and the Distribution of Income: The Importance of Factor Specificity, Substitutability, and Intensity in the Short and Long Run," *Journal of Political Economy* 82 (November 1974), pp. 1191–1204. Based on these two articles, the approach is sometimes known as the Mayer-Mussa framework. For a useful summary and geometric representation of the short-term and long-term adjustment processes, along with a critique of the Heckscher-Ohlin assumption of intersectoral capital mobility, see J. Peter Neary, "Short-Run Capital Specificity and the Pure Theory of International Trade," *The Economic Journal* 88 (September 1978), pp. 488–510.

In the specific-factors approach, which I regard as most useful to the task at hand, the economy is organized into activities (or sectors) to which factors are specific, along with factors that can move freely from activity to activity. The classic setup is an economy in which capital is specific either to the production of clothing or to the production of housing, while labor is an input for both sectors and can move freely from the garment industry to the construction industry. The result, as mentioned above, is that changes in the prices of goods have their principal effects on the specific factors, with collateral (and generally ambiguous) effects on the mobile factor. In the above example, an increase in the relative price of clothing, perhaps due to a tariff, is good for capital in the garment industry and bad for capital in the housing industry; its effect on labor depends on the mix of clothing and housing that workers consume. If, however, the supply (thus, the price) of the mobile factor changes, the interests of the specific factors are opposed to those of the mobile factor. In the above example, if the supply of labor shrinks and wages rise, this is unambiguously good for workers and bad for capital in the garment and construction industries, since the price of their labor input rises.[25]

The application of the specific-factors approach to our problem is straightforward. I clarify again that with capital mobility I mean the mobility of financial capital rather than sector-specific capital. A secular increase in international capital mobility implies movement of financial assets from capital-rich to capital-poor countries (from low to high interest rates) and therefore an increase in the supply of finance to countries poor in capital and a reduction in the supply of finance to countries rich in capital. Specific factors in capital-poor countries do well, since they can now borrow at lower interest rates; specific factors in capital-rich countries do badly, since they must now pay higher interest rates; and owners of liquid financial assets in capital-rich countries do well, while those in capital-poor countries do badly.

I should note that the distinction made here between capital-rich and capital-poor countries may be somewhat misleading, or at least incomplete. Capital flows in response to differences in rates of return, and interest rates can vary for reasons other than underlying endowments of capital. The United States was a net capital importer in the 1980s not because it had suddenly become capital-poor but, rather, because national savings were insufficient to finance domestic investment; foreign savings were especially needed to help fund the government budget deficit. By the same token, many developing countries became net capital exporters during the 1980s, as they lost access to overseas finance and had to service their existing debts. Countries can import

25. In a slight variation on the usual specific-factors or Ricardo-Viner model, the one presented here implies that there are both mobile and specific forms of both labor and capital. The effect of relative price movements and changes in endowments thus depends in part on the potential substitutability of the forms of factors or the factors themselves—for example, substitutability of mobile for specific labor or of mobile labor for mobile capital. For our purposes, it is sufficient to stop with the simpler version. Adding complexity to the model does not fundamentally change the analytic points; it only changes the details of their empirical application.

or export capital for reasons that have little to do with their endowments, especially over the short and medium run. Nonetheless and over the longer run, developed countries tend to be net capital exporters, while developing countries tend to be net capital importers. The point is simply that actual applications require attention to specific national circumstances.

In any case, I believe that the specific-factors model has three important features which make it useful for the analysis of the political economy of international finance. First, it emphasizes the political relevance of short-term fluctuations in the returns to different sorts of economic activity, rather than longer-term changes in the conditions of workers or capitalists as a class. Second, it assumes that most people and investments are "caught" in their current activity to one degree or another. To be sure, some are more caught than others, but there is no recourse to the highly unrealistic assumption common in other models that, for example, automobile workers faced with import penetration will have no trouble finding jobs at the same wage in another industry. Third, it recognizes that some factors may be mobile, while others are specific. For example, it is consonant with the specific-factors approach to assume that unskilled labor is quite mobile among industries, while skilled labor is industry-specific, or to assume that financial capital is mobile among industries, while physical capital is industry-specific. This feature allows for variations in the degree to which people or investments are "stuck" in one place. These three interrelated emphases—on the political significance of the short run, on the relative specificity of most people and investments to their current activity, and on the possibility that some factors are more mobile than others—seem both realistic and analytically useful.

For those unfamiliar with the method, it may be helpful to identify it as a sectoral approach to political economy as opposed to a class-based approach.[26] In the class-based approach, differences among workers are less important than differences between workers and capitalists; the same is held to be true of capitalists and landowners. Politics is competition among these classes, not within them. In the sectoral approach, steelworkers have cross-cutting interests. On the one hand, they are workers, and their interests in the long run are similar to those of other workers. On the other hand, they produce steel, and their interests in the short run are similar to those of managers and shareholders in the steel industry. Politics, in this view, is primarily competition among various sectors of the economy, although long-term class interests sometimes play a role.

The specific-factors or sectoral view of the world tells us a great deal about the distributional implications of capital mobility. As indicated above, as we

26. I refer here to those Marxist (and non-Marxist) views that assume labor-capital contradictions to be the principal axis of political conflict. Many other Marxists focus on intraclass differences or blocs; for a good example of relevance to the issue at hand, see Stephen R. Gill and David Law, "Global Hegemony and the Structural Power of Capital," *International Studies Quarterly* 33 (December 1989), pp. 475–99.

move from a BCM to an ACM world, financial capital leaves areas where rates of return are lower and enters areas where they are higher. Interest rates go up in capital-exporting regions and down in capital-importing regions; interest rate variations affect not only owners of financial assets but also borrowers, for whom they are a cost of production. In comparison with the BCM world, in the ACM world things are better for owners of financial assets in capital-exporting countries and for owners of sector-specific assets (capital, skills, and land) in capital-importing countries, and vice versa.

We can also introduce another important set of economic actors: internationally diversified (multinational) corporations. In the specific-factors view of the world, a crucial dimension of variation is the mobility or specificity of an asset, be it an investment, skill, or plot of land. In many ways, the dimension of diversification parallels that of specificity. An investor who holds an asset that can easily be moved from use to use is in a parallel position to an investor whose asset portfolio includes a large number of different economic activities. The most vulnerable position is to hold an asset that is completely specific to one industry; it is analogously vulnerable to have an asset portfolio that includes firms in only one industry.[27] In this sense, firms with operations that are diversified with respect to activity and location can be regarded as less specific and more mobile than firms whose operations are "stuck" in one activity and one place. The preferences of multinational corporations, with operations in many countries facing different conditions, thus parallel the preferences of investors with more mobile assets and diverge from those of nationally and sectorally specific corporations.[28]

A simple "map" of sectoral interests can thus be drawn in line with the specific-factors approach. On this map, increased capital mobility is generally good for financial asset-holders in the developed world and bad for those in the developing world; it is good for multinational corporations; and it is bad for (nonmultinational) specific factors in the developed world and good for those in the developing world.[29]

27. The point is not that portfolio diversification is the same as asset mobility but, rather, that the policy implications are parallel. A more sophisticated but somewhat more controversial version of this argument might focus on multinational corporations as combinations of intangible assets within a vertically integrated firm; the relevant literature is surveyed by Martin Perry in "Vertical Integration: Determinants and Effects," in R. Schmalensee and R. D. Willig, eds., *Handbook of Industrial Organization,* vol. 1 (Amsterdam: North-Holland, 1989), pp. 183–255. Inasmuch as such assets can more easily be moved within multinational corporations, this does in fact make the assets of these corporations more geographically mobile than those of other firms in similar industries. See, for example, Daniel M. Shapiro, "Entry, Exit, and the Theory of the Multinational Corporation," in Charles P. Kindleberger and David B. Audretsch, eds., *The Multinational Corporation in the 1980s* (Cambridge, Mass.: MIT Press, 1983), pp. 103–22.

28. For an application of similar ideas to the cases of U.S. and French trade policies in the 1920s and the 1970s, see Milner, *Resisting Protectionism.*

29. It is worth emphasizing again that these conclusions abstract from many specifics that may indeed override them. For example, in the early 1980s, financial asset-holders in many Latin American countries benefited strongly from capital mobility. In the context of political instability and strong and unsustainable currency appreciations, they were able to get their money out of

A few examples indicate the plausibility of this sectoral map. The opening of global financial markets to the less developed countries (LDCs) was good for industries in the Third World, which were suddenly able to borrow at reduced rates of interest. Industrial production in the LDCs grew rapidly as foreign finance flowed in, benefiting owners and managers (and usually workers) in these industries.[30] By the same token, overseas lending from developed countries almost certainly raised the cost of capital to industries at home, contributing to the problems of industrial sectors in Western Europe and North America. More generally, the increased financial integration of the advanced industrialized countries strengthened competitive pressures on specific industries and contributed to the industrial restructuring taking place in them.[31]

In line with the approach, the interests of two groups—the owners and managers of financial assets and the multinational corporations—are opposed to those of the specific factors, so that financial and multinational interests in the developed countries are expected to diverge from the interests of specific nationally based industrial sectors. This would appear a fair generalization from the experience of the 1970s and 1980s. The principal beneficiaries of the broad economic trends of the last two decades have been internationally oriented firms and the financial services industries; the principal losers have been nationally based industrial firms.[32]

These conclusions about the distributional effects of increased financial integration can be turned around to predict expected patterns of political support and opposition to policies that will increase international capital mobility. Perhaps the most obvious policies in this regard concern the removal of barriers to capital movements across borders, but they also include efforts to strengthen organizations that police international financial markets, especially the International Monetary Fund (IMF).

In the developed world, I expect support for increased financial integration from owners and managers of financial assets and from multinational firms with

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Latin America and to overseas bank accounts. On the process, see Donald Lessard and John Williamson, eds., *Capital Flight and Third World Debt* (Washington, D.C.: Institute for International Economics, 1987). Clearly, other characteristics of these political economies outweighed the tendencies discussed here.

30. For a more detailed argument to this effect, see Jeffry A. Frieden, "Third World Indebted Industrialization: State Capitalism and International Finance in Mexico, Brazil, Algeria, and South Korea," *International Organization* 35 (Summer 1981), pp. 407–31. The degree to which workers and others benefited from the capital inflow would depend, in this framework, on how specific their assets were.

31. For an elaboration of this argument, see Frieden, *Banking on the World,* especially pp. 196–246.

32. Much of this discussion abstracts to an extent from the effects of specific policy episodes, such as those involving the United States in the 1980s. I return to this problem in the following section of the article. My discussion here also does not take into account such significant national variations as different rates of productivity growth on the part of domestically based firms.

internationally diversified investments.[33] I expect opposition to increased financial integration from specific industries, especially those tied to a particular national market. It is my opinion that this accurately, albeit in the broadest terms, describes patterns of political activity on these issues. In the United States, support for financial deregulation, including deregulation of international financial relations, has come primarily from the country's financial centers and its internationally oriented nonfinancial corporations; domestic manufacturing and farm groups have been ambivalent or hostile.[34] By the same token, support for American backing of the IMF has been strongest in these sectors, while again opposition to government commitments to the international financial order have been concentrated in the industrial and agricultural heartlands.[35]

Europe's leading financial and multinational firms have been the stronghold of support for breaking down remaining barriers to EC financial and monetary integration.[36] Although systematic evidence is not available, indications are that the strongest backers of financial deregulation are in the EC's leading financial centers.[37] The chief Japanese promoters of international financial deregulation have been, again, financial and multinational firms. In Japan, the issue is complex, with major battles within the financial community over the contours

33. This must be qualified on the basis of the institutional and industrial structure of the various sectors. For example, in cases in which the domestic financial services industry or subsections of it are local cartels, financial integration may serve to undermine the cartel. Such nuances are of course important, but so broad a sweep as in this article cannot do them justice.

34. See David Dollar and Jeffry Frieden, "The Political Economy of Financial Deregulation in the United States and Japan," in Giacomo Luciani, ed., *Structural Change in the American Financial System* (Rome: Fondazione Olivetti, 1990), pp. 72–102. Again, this generalization ignores specific national policy episodes, such as that involving American capital imports in the 1980s. In my own defense, however, I can note that those involved in political debates over the regulation of international financial flows to and from the United States do appear to have longer-term considerations in mind.

35. For details on the 1983 IMF quota increase debate, see Frieden, *Banking on the World,* pp. 179–90.

36. Again, as mentioned above, this should be qualified with careful attention to national institutional differences. In such countries as Spain and Italy, the national banking system tended to function as a protected cartel, so that the removal of capital controls and financial regulations may have harmed segments of the financial community. The issue is not clear-cut; banks might support the removal of capital controls but oppose the entry of foreign banks, and the stronger local banks might welcome deregulation if this would allow them to begin building relations with banks abroad. This is, of course, a topic on which further research must be done.

37. See Benjamin J. Cohen, "European Financial Integration and National Banking Interests," in Pier Carlo Padoan and Paolo Guerrieri, eds., *The Political Economy of European Integration* (London: Harvester Wheatsheaf, 1989), pp. 145–70. For an interesting perspective on the implications of financial deregulation, see the following works of Vittorio Grilli: "Financial Markets and 1992," *Brookings Papers on Economic Activity,* no. 2, 1989, pp. 301–24; and "Europe 1992: Issues and Prospects for the Financial Markets," *Economic Policy* 9 (October 1989), pp. 388–421. Regarding the important issue of the U.S. response to European and Japanese policies, see Thomas Bayard and Kimberly Ann Elliot, "Reciprocity in Financial Services: The Schumer Amendment and the Second Banking Directive," mimeograph, 1990.

of the regulatory changes. Nonetheless, the general patterns appear consonant with the approach set forth here.[38]

To summarize this section, the distributional effects of increased cross-border capital mobility can be striking. In a general and long-term sense, it may be that international financial integration increases the influence of capital by making it easier for owners of financial assets to take them abroad in response to national policies they do not like. The more immediate results in the developed world have been to drive a wedge between two camps, the first consisting of the financial sector, owners of financial assets, and integrated multinational firms, all of which have gained with financial integration, and the second consisting of firms specific to a particular industry and location, all of which have been harmed by the generally increased competition for scarce loanable funds. The clear prediction is for conflict between these "integrationist" forces and "anti-integrationist" forces. But political debate has not been and will not be restricted to policies directly concerned with increasing or retarding international capital mobility, and it is to the distributional and political implications of financial integration itself for these other debates that we now turn.

The distributional effects of economic policies in a financially integrated world

While the political divisions likely to emerge over the desired degree of international financial integration are important, the general increase in international capital mobility is also likely to change interest group activity on a wide range of other economic policy problems. Global financial integration has already shifted much political activity directly or indirectly toward the exchange rate in ways that imply new socioeconomic and political divisions. It raises problems of international policy cooperation that may be too new to analyze in detail. And, in some ways, financial integration may have an impact on the strength of sectoral lobbying. This section surveys these expected effects. Again, the problem here is not to do with the level of financial integration itself; I take as given a high level of international capital mobility in order to see how this level affects political behavior and policy in other realms.

38. Two excellent studies are Louis W. Pauly's *Opening Financial Markets: Banking Politics on the Pacific Rim* (Ithaca, N.Y.: Cornell University Press, 1988) and Frances McCall Rosenbluth's *Financial Politics in Contemporary Japan* (Ithaca, N.Y.: Cornell University Press, 1989). In Japan, as in some European nations, members of the banking community were reluctant to see international competition threaten their domestic cartel, but the rapid globalization of financial markets appears to have led them to regard deregulation as the better of two evils. For a more detailed elaboration of this argument, see Dollar and Frieden, "The Political Economy of Financial Deregulation in the United States and Japan." For an argument that is complementary in many ways to the one presented here, see John Goodman and Louis Pauly, "The New Politics of International Capital Mobility," mimeograph, Harvard University Business School and University of Toronto, 1990.

One preliminary observation has to do with the potential effects of increased international capital mobility on the intensity of sectoral interests of owners of capital. The starting point is that the more specific the asset is to its current use—that is, the more substantial is the cost attached to moving the asset from its current use to its best alternative use—the more incentive the owner of the asset will have to lobby for supportive government policies.[39] Agents in a sector to which exit and entry are costless have little or no incentive to spend time, energy, and money to get government support, since this support will be dissipated by new entrants into the sector.

To pick up from the previous discussion of the effects of financial capital mobility on sectoral policies, inasmuch as global financial integration makes it easier for investors to get into or out of a particular sector, it reduces the incentive for sectoral lobbying. Although there is little evidence that this effect has been large, it is theoretically plausible. An integrated worldwide financial market of enormous size, compared with many segmented national markets, might indeed allow for the development of instruments and mechanisms that would facilitate the redeployment of capital from one use to another. These could include broader and deeper futures markets and insurance schemes, better information to potential borrowers and lenders, and more readily available venture finance.[40]

If indeed international financial integration does reduce barriers to entry and exit of investors to and from specific economic activities, it could reduce the sectoral orientation of lobbying by investors.[41] If financial integration makes it easier for firms to exit and enter many different sectors, their attachment to a particular sector may be reduced. Inasmuch as this takes place, we might

39. There are a number of ways of thinking about this. In one, the result obtains because difficulty of exit from a sector constitutes a barrier to entry to it: the knowledge that investment in the sector contains an important irreversible component will reduce the likelihood of new investors entering in response to relative price changes that may not be permanent. In this sense, barriers to exit *are* barriers to entry; since entry barriers increase the effectiveness of sector-specific policies in aiding existing agents in the sector, they increase the returns to political lobbying.

40. Possibilities such as these tend to imply imperfect competition—increasing returns and learning-by-doing—in the financial sector, which is almost certainly the case. For a representative theoretical approach along these lines, see Stephen D. Williamson, "Increasing Returns to Scale in Financial Intermediation and the Non-Neutrality of Government Policy," *Review of Economic Studies* 53 (October 1986), pp. 863–75.

41. This is just a restatement of the general notion that the capital markets and political lobbying are in some sense substitutes (albeit imperfect ones). This idea sounds absurd to most political scientists, but perform the following thought experiment: if import-competing automobile manufacturers could sell all of their equipment to the Japanese at a price that would allow them to make a market profit, their incentive to engage in costly and time-consuming lobbying for protection would be much lower. Or, alternatively, if autoworkers could in some way sell their skills and their seniority to Japanese autoworkers for an amount equal to what they might have hoped to earn with these skills and seniority, their incentive to lobby would be lower. The fact that markets for these assets are incomplete or nonexistent simply serves to point out that the politicization of the issue is expected. While there are not markets for these assets, there are good markets for other assets—and we expect owners of such assets to be less politically active.

expect more political action by owners of capital as a class and less participation of capitalists in sectoral lobbying.

However, as argued above, even if this trend exists, it is embryonic and its impact has yet to be felt: the sector specificity of capital has not been measurably reduced by international financial integration. The most prominent effect of increased capital mobility is not on the level of sectoral lobbying but, rather, on the character of sectoral lobbying and the policy preferences arising when the sectors are thrown together in pursuit of government support.

The impact of capital mobility on the expected political lineup over macroeconomic policy is in fact striking. Two interrelated dimensions of policy choice are especially important: the degree of exchange rate flexibility and the level of the exchange rate itself. With regard to the first dimension, the Mundell-Fleming conditions serve as a point of reference.[42] Recall that, with capital mobility, a country faces something of a trade-off between exchange rate stability and monetary policy autonomy: the more the country's exchange rate is held constant, the less its monetary policy can deviate from that of the rest of the world. While some actors will favor a low degree of exchange rate flexibility (a fixed rate such as the gold standard) despite the loss of monetary policy autonomy, others will be willing to accept a high degree of exchange rate flexibility (freely floating rates) in exchange for policymaking autonomy. With regard to the second dimension, which is the preferred level of the exchange rate itself, some fixing of exchange rates is assumed. While some actors will prefer a high (more appreciated) exchange rate, others will prefer a low (more depreciated) exchange rate. The two dimensions and the expected policy preferences of socioeconomic actors along them are presented in Figure 1 and discussed in detail below. We should keep in mind that the figure provides only rough approximations; variation is, of course, along a continuum rather than dichotomous.

The first dimension involves the desired degree of exchange rate flexibility, which can be presented most starkly as whether the rate should be fixed or flexible. Fixing the rate in a world of mobile capital implies forgoing national monetary policy autonomy in favor of greater certainty about the value of the currency; in other words, it gives priority to a stable exchange rate over the ability of national policy to affect domestic prices. This is especially attractive to two groups of actors whose economic activities directly involve international trade and payments and who therefore are highly sensitive to currency fluctuations. International traders and investors and the producers of export-oriented tradable goods tend to suffer from exchange market volatility, since it

42. Some complications may result from this melding of the Mundell-Fleming and specific-factors models. The Mundell-Fleming model generally assumes some unutilized resources and some wage stickiness, while the specific-factors model does not. The contradiction may be relevant for the analysis of effects on national welfare, but it does not appear to matter much for the short- and medium-term distributional effects, which are the focus here. For a discussion, see Corden, *Inflation, Exchange Rates, and the World Economy,* pp. 22–34.

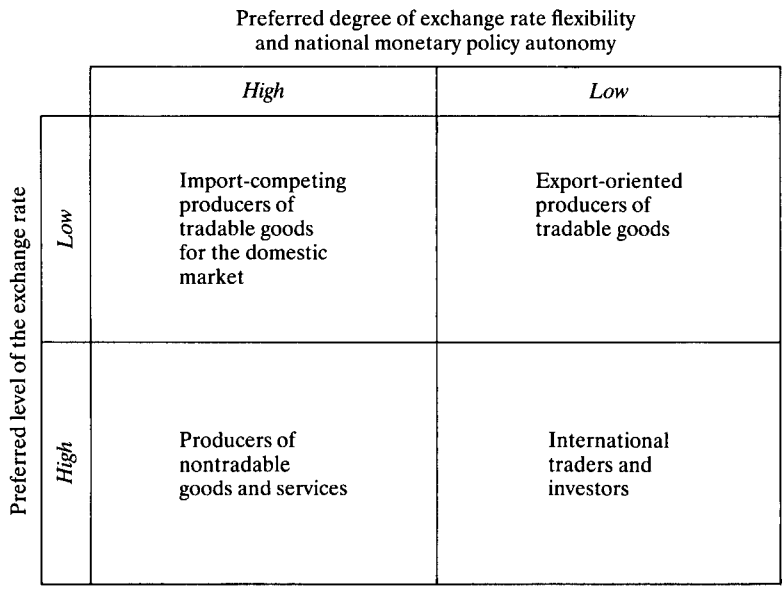

FIGURE 1. *Synopsis of the policy preferences of various socioeconomic actors in a world of mobile capital*

makes their business riskier.[43] By the same token, these actors are relatively unconcerned about domestic macroeconomic conditions, since they can respond to depressed local demand by shifting their business to other countries.

In contrast, two other groups of actors tend to be highly concerned about domestic macroeconomic conditions and thus favor the national monetary policy autonomy made possible by a flexible exchange rate. The first of these groups consists of producers of nontradable goods and services. Since their business does not involve the use of foreign exchange and since currency volatility has only indirect effects at best on them, they tend to have no clear preference for stable exchange rates.[44] The second group consists of producers of import-competing tradable goods for the domestic market, who tend to be relatively indifferent about exchange rate volatility (which may even reduce import pressure inasmuch as it makes importing riskier) and primarily concerned about policymaking autonomy.

The preferences of the various groups are relevant, most prominently, to policy debates about stabilizing exchange rates. Based on the above arguments,

43. There are exceptions: producers of tradable goods in which competition is not primarily on price (and is instead, for example, on quality) will be less sensitive to exchange rate movements.

44. Inasmuch as a devaluation changes the price of tradable goods relative to that of nontradable goods, it affects producers in the nontradables sector. However, such price volatility affects all national nontradables producers more or less equally and is therefore far less significant to them than it is to tradables producers, who see their output change in price relative to that of their competitors.

we can expect multinational firms, international investors more generally, and internationally oriented producers of tradable goods to be more sympathetic to currency stability, while we can expect producers in the nontradables sector and producers of import-competing tradable goods to be most interested in national monetary policy autonomy.

In policy debates about the level of the exchange rate, which is the second dimension noted in Figure 1, we can expect the interests of various economic sectors to track the relative price changes involved in depreciation or appreciation of the currency. From a differential distributional standpoint, the lower (more depreciated) the exchange rate, the higher is the price of tradable goods relative to nontradable goods. This, of course, tends to help producers of tradable goods—whose output prices rise more than the prices of the nontradable inputs they use—and to hurt producers of nontradable goods. Producers in the tradables sector therefore favor a weaker currency that makes their products more competitive in home and foreign markets. In contrast, producers in the nontradables sector generally benefit from currency appreciation, which raises the domestic relative price of their products and lowers the domestic relative price of tradable goods.[45] Similarly, international traders and investors, who are interested in purchasing assets overseas, favor a strong currency.[46]

45. For those unfamiliar with the approach, the real exchange rate can be expressed as the relationship between the price of nontradable goods and that of tradable goods. By assumption, the price of tradables is set on world markets and cannot be changed (in foreign currency terms) by national policy. In other words, the foreign currency price of tradables is an anchor around which domestic prices move. Depreciation makes tradables relatively more expensive in domestic currency terms, while nontradables become relatively cheaper. Appreciation has the opposite effects. In the real world, these effects can be offset, for example by characteristics of product markets, but there is little doubt that the general pattern holds. When the dollar was strong, the dollar prices of television sets and clothing were low, while the price of housing soared. As the dollar fell, the dollar price of hard goods rose, while the price of housing stagnated or declined. Despite some controversy about the approach, it is close enough to consensual to warrant its use.

One important consideration to keep in mind is the extent to which the relative price effect (say of an appreciation on raising demand for nontradable goods) may be counteracted by the macroeconomic effect (say of reduced aggregate demand more generally); this is, so to speak, the contest between the income and substitution effects or between expenditure reduction and expenditure switching. For a useful survey and application to the LDCs, see Sebastian Edwards, *Real Exchange Rates, Devaluation and Adjustment* (Cambridge, Mass.: MIT Press, 1989). For more technical essays, see John Bilson and Richard Marston, eds., *Exchange Rate Theory and Practice* (Chicago: University of Chicago Press, 1984). Another point to keep in mind is that the nontradable goods and services sector includes those who operate behind prohibitive barriers to trade (especially quotas).

46. Of course, from the standpoint of an overseas investor, the desire for a strong home currency to allow greater purchases of overseas assets is balanced by the desire to maximize home currency earnings from these assets, which demands a weak home currency. The best possible scenario, as usual, is to buy cheap and sell dear—that is, to buy foreign currency when the home currency is strong and sell it when the home currency is weak. There are a number of defensible theoretical reasons why international investors might favor strong home currencies; it is probably enough to note here that empirically they tend to do so. On the relationship between foreign direct investment and the exchange rate, see Steven W. Kohlhagen, "Exchange Rate Changes, Profitability, and Direct Foreign Investment," *Southern Economic Journal* 44 (July 1977), pp. 43–52.

Preliminary evidence seems to bear out these expectations both on the dimension of exchange rate flexibility and on that of the level of the exchange rate itself.[47] Perhaps the arena in which the choice between monetary policy autonomy and currency stability has been posed most directly is in the development of the exchange rate mechanism of the European Monetary System (EMS) and the subsequent movement toward a single EC currency.[48]

The above discussion has systematic predictions about private-sector attitudes toward the exchange rate mechanism (ERM) of the EMS.[49] I expect the ERM to be most favorable for, and to evince the most enthusiasm from, firms in the financial sector, major exporters, and diversified multinational corporations with major investments or customers in the EC. Evidence is scanty, but some can be presented. One study of potential British winners and losers from Britain's affiliation with the ERM essentially tracks my expectations. Internationally oriented manufacturing and finance and related services were expected to do well, while the domestically oriented manufacturing and services sectors were expected to be weaker.[50] Of Britain's twelve corporate members in the Association for Monetary Union in Europe, a private-sector lobbying organiza-

47. Practically the only systematic empirical study on these issues in recent years is I. M. Destler and C. Randall Henning's *Dollar Politics: Exchange Rate Policymaking in the United States* (Washington, D.C.: Institute for International Economics, 1989), which appears to bear out some of these observations. The issue is somewhat clouded by the difficulty, which Destler and Henning recognize, of separating debates over the level of the exchange rate from debates over its volatility; in the early 1980s in the United States, the former tended to dominate the latter. The authors note that international financial institutions benefit from exchange market volatility, which can make their trading desks extremely profitable. However, they should—and many do—weigh this benefit against the cost of international business foregone because of uncertainty about currency values. At least some portion of the international business of American money-center banks is due to the widespread belief in the reliability of the dollar and the American macroeconomic environment more generally.

48. The literature on the EMS is now enormous, and almost all of it is purely economic in content. For an excellent survey along these lines, see Francesco Giavazzi and Alberto Giovannini, *Limiting Exchange Rate Flexibility: The European Monetary System* (Cambridge, Mass.: MIT Press, 1989). For a good study that discusses many of the domestic and international political aspects of the EMS, see Peter Ludlow, *The Making of the European Monetary System* (London: Butterworth, 1982); unfortunately, events have moved far beyond what Ludlow described in 1982.

49. I avoid three issues that are more closely associated with a single currency per se: the potential welfare costs of reduced seignorage opportunities, the welfare gains associated with reduced transactions costs, and the potentially differential impact of these reduced transactions costs on various economic agents. I focus entirely on the more immediate issue of the differential effects of fixed but adjustable exchange rates within the EMS. For a discussion of some of these other issues, see Barry Eichengreen, "One Money for Europe?" *Economic Policy* 5 (April 1990), pp. 118–87.

50. See S. G. Warburg Securities, *Into the ERM: The Outlook for the UK Economy and Equity Market,* London, August 1990. A summary table is on p. 31, but more useful sectoral summaries are on pp. 32–52. The projections are complicated a bit (for our purposes) by the study's conflation of greater exchange rate stability with a firmer pound sterling, both of which it expects to ensue but which may operate in slightly different directions distributionally, as I discuss below. The study also notes that while 45 percent of profits from firms in the *Financial Times* stock exchange index are from overseas activities (exports and profits of foreign affiliates), only 13 percent come from the EC and 17 percent from North America. This may help explain some of the British reluctance to tie sterling to the ERM, especially at a time when the European currencies were appreciating strongly against the dollar.

tion for rapid currency union, eight are from firms in the financial and related services sectors, two are from diversified multinational corporations, and two are major exporters.[51] In the absence of systematic empirical work, few serious assessments can be made, but the patterns are suggestive.[52]

The second dimension, the level of the exchange rate, is a familiar topic of debate in many countries, especially those for which international trade is very important and those which have a history of exchange rate volatility (characteristics that apply primarily to developing and small developed countries). Political conflict over the exchange rate has become important in larger nations as well. One striking example is the United States, where between 1981 and 1986 much of the political activity that might otherwise have taken the form of pressure for trade protection instead focused on trying to get the authorities or other actors to force the dollar to depreciate relative to the currencies of the country's major trading partners.[53] The evidence, especially from the United States in the 1980s, appears consonant with the expectations presented above.[54]

These varying exchange rate preferences in turn affect preferences toward different macroeconomic policies. With capital mobility, an expansionary monetary policy leads to depreciation of the currency, while an expansionary fiscal policy leads to appreciation. Producers of tradable goods should thus prefer monetary expansion, and producers of nontradable goods and services should prefer fiscal expansion. This will especially be the case if the fiscal expansion takes the form of a direct or indirect increase in spending on nontradable goods, which is quite likely where government spending is involved (defense, infrastructure, and social spending are generally nontradables). This may help explain the peculiar pattern of U.S. economic policy during the Reagan years. With the administration's principal bases of support in the defense community, in real estate and related sectors, and in the international investors group, pressures were for increased spending on nontradables. The resultant appreciation might have been countered by monetary expansion, as was in fact demanded by the tradable goods producers hurt by the import surge, but the nontradables constituencies wanted it reinforced by tight money, not dissipated. In other words, the mix of loose fiscal and tight monetary policies may have been less a mistake, as most economists and observers

51. The twelve corporate members are Barclays, British Aerospace, British American Tobacco, British Petroleum, Citibank, Ernst and Young, Goldman Sachs, Imperial Chemical Industries, Midland Montagu, Salomon International, Shearson Brothers, and S. G. Warburg. The Association of Corporate Treasurers is also a member.

52. For an evaluation of many of these developments, see Jeffrey Frankel, "The Making of Exchange Rate Policy in the 1980s," mimeograph, University of California at Berkeley, 1990. Again, the political economy component of Frankel's discussion focuses, as did most of the debates, on the level of the exchange rate rather than on its volatility.

53. In *Dollar Politics,* pp. 17–80, Destler and Henning provide an excellent interpretive survey of the course of dollar politics and policies over the 1980s.

54. For descriptions of the interplay of the various interest groups, see Destler and Henning, *Dollar Politics;* Frankel, "The Making of Exchange Rate Policy in the 1980s"; and C. Randall Henning, "International Monetary Policymaking Within the Countries of the Group of Five," mimeograph, 1990.

concluded at the time, than it was a reflection of the dominance of political pressures from nontradable goods producers and other supporters of a strong dollar over tradable goods producers who wanted a weaker dollar.

Another issue that has gained in importance in a world of great capital mobility is international policy coordination. Because financial integration can make it difficult for national authorities to pursue macroeconomic policies that differ from those of their financial "neighbors," it may make sense to coordinate such policies. This would, for example, avoid competitive currency depreciations, in which a country pursuing an expansionary monetary policy and thus currency depreciation against its trading partners finds itself foiled as its partners match the monetary expansion and depreciation, leaving the currencies' relative levels unchanged. Alternatively, countries trying to prevent their currencies from depreciating might unnecessarily bid up interest rates in a competitive attempt to avoid a capital outflow. The obvious solution to such problems is for the relevant policymakers to cooperate in targeting exchange rates and other macroeconomic indicators.[55]

There are many potential problems with international macroeconomic policy coordination. Some believe that such government intervention is less desirable than letting the markets take their course; others believe that the difficulties of coordination are nearly insurmountable.[56] Among the coordination problems is that slight divergences in views among national policymakers may make welfare-improving cooperation extremely difficult.[57] It is indeed likely that the domestic political underpinnings of the potential cooperating governments will differ, leading to different preferences or interpretations about the gains from cooperation and how they might best be achieved.

In this light, once again the differential domestic distributional effects of such policy coordination are relevant. Not surprisingly, I expect those whose economic activities are most sensitive to foreign financial and exchange market conditions to be most favorable to the sacrifice of national policy autonomy implied by policy coordination. International investors, traders, and the like are apt to be well disposed, while those in the nontradables sector—whose businesses may be harmed by the sacrifice of autonomy with little or no corresponding benefit from coordination—are prone to be opposed. A related set of issues has to do with the coordination of other national policies, such as

55. One influential and controversial proposal was offered by John Williamson and Marcus Miller in *Targets and Indicators: A Blueprint for the International Coordination of Economic Policy* (Washington, D.C.: Institute for International Economics, 1987).

56. For some representative surveys of this rapidly growing literature, see Martin Feldstein, ed., *International Policy Coordination* (Chicago: University of Chicago Press, 1988); and Jeffrey Frankel, *Obstacles to International Macroeconomic Policy Coordination,* Princeton Studies in International Finance no. 64 (Princeton, N.J.: Department of Economics, International Finance Section, 1988).

57. For a demonstration of this point, see Jeffrey Frankel and Katharine Rockett, "International Macroeconomic Policy Coordination When Policy-Makers Do Not Agree on the True Model," *American Economic Review* 78 (June 1988), pp. 318–40. The argument is controversial; among other things, it assumes that policymakers try to maximize national welfare, ignores the potential costs of not cooperating (or not appearing to cooperate), and makes it difficult to explain circumstances in which coordination has apparently been achieved.

taxation.[58] On this subject, there is so little analytic work and indeed so little experience in the real world that coordination is mostly speculation. However, both the trends within the EC and the discussions among other developed countries indicate that it will likely be a topic of great importance in the 1990s.

These observations have to do with the interests in play, not necessarily with the outcome of political conflict among them. Political and policy outcomes will of course depend on how intense preferences are, how concentrated and organized the various interests are, and how political and other social institutions influence their interaction. How successful the various interest groups will be at obtaining their objectives will vary from case to case and from country to country. Nonetheless, a clear understanding of the economic interests involved is a crucial starting point for analysis.

This section can be summarized quite simply. Financial integration has implications for the distributional effects—and therefore the politics—of national policies. Over the long run, access to broader and deeper financial markets may tend to reduce the sectoral specificity of capital and thereby dampen some sectoral demands—but this gradual process is unlikely ever to *eliminate* such demands. The more immediate implication is that political lineups over macroeconomic policies are likely to change quite significantly.

A trade-off between national macroeconomic policy autonomy and exchange rate stability has developed, with international investors and traders more willing to give up autonomy for stability and with the nontradables and domestically oriented sectors more interested in autonomy than in fluctuations in the exchange rate. Conflict has intensified not only over the flexibility but also over the level of the exchange rate. While support for monetary expansion and depreciation has tended to come from producers of tradable goods, support for monetary contraction and appreciation has come from international investors and producers of nontradable goods and services. At the same time, the coordination of national macroeconomic policies has become an important political problem at both the international and the domestic level. Not surprisingly, those for whom overseas economic conditions are more relevant (international investors and traders and producers of tradable goods) will favor more coordinated policies—and thus a surrender of more national policy autonomy—than will those for whom domestic conditions are determinant.

Conclusions

Without repeating the points made in the article, I can emphasize a few conclusions. Hampered as national governments may be or appear to be in the

58. See, for example, Alberto Giovannini, "National Tax Systems Versus the European Capital Market," *Economic Policy* 9 (October 1989), pp. 346–86.

face of an internationally integrated financial system, they continue to have weapons in their policy arsenal. These weapons may not be as sharp or numerous as before, but they exist. Many sectoral policies can be effective, as can macroeconomic policies if policymakers allow the exchange rate to vary.

However, the distributional implications of international capital mobility are striking. In the long run, owners of capital have probably gained relative to other groups. In the shorter run, owners and workers in specific sectors in the developed world face serious costs in adjusting to increased capital mobility.

International capital mobility also changes the pattern of lobbying over national policies. It may, over the long run, dampen some sectoral demands from owners of capital. More specifically, and in the shorter run, it tends to shift debate toward the exchange rate as an intermediate or ultimate policy instrument, thereby driving a wedge between those more sensitive and those less sensitive to exchange rate fluctuations and between those who favor currency appreciation and those who favor depreciation. To some extent, this tracks a division of the economy between producers of tradable goods on the one hand and international investors and producers of nontradable goods and services on the other.

This article sets forth a series of propositions that can be brought to bear on a wide variety of problems having to do with the politics of the international movement of capital. Such problems, it is safe to project, will be of great analytic and policy importance in years to come. The possibility for the empirical evaluation of the approach presented here and for further theoretical and empirical elaboration is clear. As we approach 1992 and as parallel developments evolve elsewhere in the world, the opportunity for and necessity of such work will be enormous, and a better understanding of what is at stake will be of great importance.

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